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C O N F I D E N T I A L SECTION 01 OF 04 TOKYO 006817

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SUBJECT: THE ABE ADMINISTRATION'S PRO-GROWTH AGENDA: WHAT
DOES IT ENTAIL AND WHAT ARE THE IMPLICATIONS?

Classified By: CLASSIFIED BY: DCM JOSEPH R. DONOVAN FOR REASONS 1.4 (B)
AND (D)

11. (C) Summary. Prime Minister Abe has defined a pro-growth economic policy, calling for attaining more than 3% nominal economic growth in the medium run. The agenda for achieving this goal has not been fully fleshed out, though elements are being developed in a number of areas, including tax policy, the central government budget, and labor and deregulation policies. While work is ongoing separately in each of these areas under the direction of different LDP and government councils and ministries, no one, including the Prime Minister, appears to be driving the process of pulling the various elements together into a unified whole. While LDP Secretary General Nakagawa has the political power to pull

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all the players together to forge a comprehensive agenda and way forward, so far he has not done so. End summary.

12. (C) With the slogan, "no fiscal reconstruction without growth", Prime Minister Abe has defined a pro-growth economic policy by emphasizing supply-side measures. PM Abe has called for attaining more than 3% nominal economic growth in the medium run, focused on an improvement in labor productivity. Implicitly, the real economic growth target is about 2%, with an inflation rate at 1%. As of yet, the agenda for achieving this goal has not been fully fleshed out, though elements are being developed in a number of areas, including tax policy, the central government budget, and labor and deregulation policies. While work is ongoing separately in each of these areas under the direction of different LDP and government councils and ministries, no one, including the Prime Minister, appears to be driving the process of pulling the various elements together into a unified whole. While LDP Secretary General Nakagawa has the political power to pull all the players together, so far he has not done so in order to forge a comprehensive agenda and way forward. Moreover, to date, the Prime Minister himself has not availed himself of an opportunity to clearly demonstrate his commitment to further reform. Two opportunities to demonstrate his reform credentials will soon present themselves to the Prime Minister, as the GOJ determines its FY07 budget outline and as a key policy committee decides its short term agenda.

Fiscal Policy

¶3. (U) In the fiscal area, the pro-growth agenda has translated to impetus for further expenditure cuts, a delay in consideration of tax increases, particularly for the consumption tax, and proposals for corporate tax reform.

¶4. (U) The Abe Administration has been following the medium-term fiscal consolidation plan laid out by former PM Koizumi. In early July, the Koizumi Cabinet adopted a new medium-term fiscal consolidation plan with two-stage targets: (1) achieving a combined central/local government primary surplus (excluding the social security fund and interest payments on government debt) by FY2011, and (2) reducing steadily the ratio of gross government debt to GDP through the mid-2010s. Attaining the first objective is estimated to require an adjustment of 16.5 trillion yen (3.3 percent of GDP), or 3.3 trillion yen (0.65 percent of GDP) per year, on average. While tax increases and economy-driven growth in tax revenues are projected to cover 2.2 to 5.1 trillion yen of the adjustment, spending cuts are projected to cover the remaining 11.4 to 14.3 trillion yen, roughly 69 to 87 percent. The plan sets specific measures to restrain major categories of government spending over the next five-years (FY2007-11). The following is a brief description of the planned spending restraint measures:

-- Public works spending by the central government will be reduced by 3.9-5.6 trillion yen over the five-year period by cut spending between 1 to 3 percent each year. A 3 percent cut has been proposed for FY07.

-- Personnel costs of the central and local governments will be lowered an accumulated 2.6 trillion yen over the next five years by reducing the number of central and local government employees by 5.7 percent each on a net basis, largely through attrition or shifting employees to public

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corporations.

-- The central and local government's contribution to social security programs will be reduced by a combined 1.6 trillion yen over five years through tightening eligibility conditions for the welfare public assistance program, possibly cutting the central government's contribution to the employment insurance program, and reviewing the reimbursement pricing system of medical fees.

-- An "other" category that includes: reducing local government independently financed public work outlays by between 1 and 3 percent each year; cutting spending on official development assistance (ODA) by between 2 and 4 percent each year; and reducing national defense spending below the previous year's level over the next five years.

¶4. (U) As part of the yearly budget process, ministries have made budget requests far outside the spending parameters outlined above. The FY07 budget to be proposed at the end of December by the LDP will provide the first indication of whether the Cabinet's expenditure-cutting measures are on track.

¶5. (U) At the first meeting of the Government Tax Council under Prime Minister Abe, the PM touched on four issues for tax reform: improving international competitiveness to help revitalize the economy, maintaining stable revenue sources to meet the increased social security burden and declining population, increasing child-rearing assistance packages and giving autonomy to local governments. Prime Minister Abe has put off discussion of tax increases, particularly in the consumption tax, until at least next fall, after the Upper House elections to be held in July 2007. In practice, this means a tax increase could be implemented in FY09 at the earliest, following proposals that would be made in the FY08 tax reform bills. Some market participants have speculated that if tax revenues continue to outperform estimates as they have this year, a consumption tax increase could be put off until FY10 or FY11.

¶6. (U) In the corporate tax area, the immediate steps being proposed are an acceleration of depreciation allowances for corporations on buildings and equipment and allowing full depreciation of assets, rather than the 95 percent currently permitted. The press has indicated that these changes would provide 500 billion yen in tax relief to corporations for FY07.

¶7. (U) Another tax change being considered for 2007 is to reduce the tax on internal reserves of companies to promote dynamism of small and midsize companies. A tax of up to 20 percent is now levied on the internal reserves of small and midsize companies, in which the majority of shares are owned by the founding family. The measure was designed to prevent managers of family-run businesses from evading taxes by building up internal reserves. However, the business community has complained that it hampers the growth of start-up companies.

¶8. (U) Further, the temporary 10 percent tax rate on capital gains and dividends is scheduled to expire in December 2007 and April 2008 respectively, and return to the previous level of 20 percent. Financial services firms are lobbying to extend the temporary cut, though MOF and the Government Tax Council are in favor of the rate reverting to 20 percent. LDP Tax Council Chair Tsushima has indicated that some interim step might be considered to avoid an adverse impact on financial markets.

¶9. (U) Over the medium term, Government Tax Council Chairman Honma has suggested a cut in the effective corporate tax rate from just over 40 percent now to 35 percent, more in line with European corporate tax rates, while Keidanren Chairman Mitarai has called for lowering the rate to 30 percent. Each one-percentage point reduction in the corporate tax rate represents a 400-500 billion yen decline in tax revenue. A five percent reduction to 35 percent would drop tax revenues by about 2 trillion yen or about 0.4 percent of GDP. However, a decrease in the corporate tax rate might prove to be controversial with the public, given that the remaining

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half of the 3.3 trillion yen special fixed-rate individual income tax cuts will be eliminated completely starting in January 2007. A few press articles already have complained that corporations, which are achieving high profits, might be given tax breaks at the expense of consumers. Current indications are that consideration of changes in the corporate tax rate may be postponed until next year. The Government Tax Council is set to make its recommendations for FY07 tax measures on December 1.

Deregulation and Labor Market Policies

¶10. (U) Prime Minister Abe has stated that he wants the Council on Economic and Fiscal Policy (CEFP) to continue as the prime driver of the reform agenda in his administration. The CEFP, established under former Prime Minister Mori in January 2001, had played that role in the Koizumi administration, particularly under the directorship of former Minister Heizo Takenaka. Membership in the Council is comprised of the Prime Minister, the Ministers of Economic and Fiscal Policy; Finance; Economy, Trade and Industry; Internal Affairs and Communications; the Chief Cabinet Secretary; the Bank of Japan Governor and four private sector

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members. The private sector members have called for completing a transitional phase to "a new growth economy" over the next five years by setting the first two years as the "takeoff period". They have proposed seven areas for reform in the "takeoff period", and are now in the process of fleshing out a specific agenda in these areas by the end of the year. The areas are:

¶11. Innovation: Improving labor productivity through technology and innovation. An Innovation Council has been set up to prioritize sectors for investment through 2025.

¶12. "Labor Market Big Bang": This area of reform encompasses ways to improve labor productivity and address income inequalities. The Ministry of Labor has been reviewing potential legislation that could affect labor market flexibility in a number of existing advisory councils.

¶13. Open society and Asian gateway: Two aspects of this element are expanding Japan's network of FTAs and EPAs (almost exclusively in Asia) and improving operations of ports and airports to make Japan a more attractive hub for Asian transshipment. Special Economic Advisor Nemoto also has been charged with shepherding the Asian gateway project and has set up his own advisory group.

¶14. Deregulation of agricultural and other markets to expand domains in which private sector firms can participate.

¶15. Creating market-based medical and nursing care systems.

¶16. Effective management of government assets: Including the sales of government stock holdings, assets such as housing for government employees, privatization of government-affiliated financial institutions such as Japan Post, and sales of loan claims from the FILP program.

¶17. Decentralization: improving administrative services in accordance with regional needs by giving more autonomy to local governments.

¶11. (SBU) A number of these areas are likely to prove controversial with other Cabinet officials and the bureaucracy, particularly the deregulation of agriculture and health systems. An important bellwether will be the specific agenda devised by the private sector members of the CEFP by the end of the year and how strongly it is backed by the Prime Minister, particularly in the face of a likely backlash from particular ministries and vested interests, such as farmers and doctors.

¶12. (SBU) Another dimension of controversy in the CEFP is the view of Bank of Japan (BOJ) Governor Fukui on the growth targets implicit in the pro-growth agenda. The BOJ's general stance is that the real growth rate should slow toward its potential, which is estimated at 1.5-2.0 percent, while in the medium term, inflation should remain in the 0-2 percent range. BOJ is closely watching economic data to determine the appropriate timing for its next rate hike, lest the current low level of interest rates result in "overinvestment" and increased inflation. This puts BOJ

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outside the mainstream in the CEFP, and sets the stage for potential conflict between the GOJ and BOJ in the future.

Overall implications

¶13. (C) As noted above, work continues in a number of areas to flesh out Prime Minister Abe's pro-growth agenda. However, aside from the slogan about growth being necessary for the future and for fiscal reform, there is no overarching plan tying the various parts of the agenda together and no single actor with the Prime Minister's backing to push through the agenda once it is fleshed out. The Prime Minister has also touted the "second chance agenda" as part of his overall policy goals. Though that does not specifically relate to the pro-growth agenda, it was devised as an attempt to deal with income inequalities that have been described by some as an outcome of the previous Administration's reform policies. Effectively relating concrete measures to provide second chances, while moving forward with pro-growth policies, might provide for more public and political support for the overall agenda. Another development that risks undermining the Abe Administration's reform credentials is potential backsliding in allowing cross border mergers and acquisitions through stock swaps ("triangular mergers"). Vested interests are pushing very hard to introduce a technicality that would make the stock

swaps practically unworkable and political leadership will be needed to resist these efforts and to support the Prime Minister's stated goal of improving the climate for FDI.

¶14. (SBU) We will be watching developments over the next several months to see if the agenda remains piecemeal under various councils and ministries, or whether it can be pulled together at the center, as well as the degree to which the agenda remains intact as vested interests start to push back.

SCHIEFFER